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21 February 1978

MEMORANDUM FOR THE RECORD

SUBJECT: Argentina: Economic Progress Under the Junta

The attached draft article on the current Argentine economic situation was forwarded on 21 February 1978 to 3.5(c) [redacted] in response to her request for an overview of the economy. If any questions, please contact 3.5(c) [redacted]

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As stated

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ERM78-10120 3.5(c)
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Argentina: Economic Progress Under the Junta

With able economic leadership and a year of favorable weather, the military government has restored Argentina's international solvency and revived economic growth. For 1978, the main economic goal is to cut the persistent triple-digit inflation. Anti-inflation measures will not, however, be allowed either to jeopardize economic recovery or to limit real wage growth enough to cause serious labor unrest. All in all, 1978 should see a satisfactory economic growth and a moderate reduction in the inflation rate.

Junta Economic Reforms

When the junta overthrew the government of Isabel Peron in March 1976, the economy was near collapse and the country was on the verge of defaulting on its foreign debt. The balance of payments was nearly $1 billion in the red and foreign exchange reserves were practically exhausted. By early 1976, private investment was at a low ebb and foreign investment nonexistent. Soaring wages and a swollen government deficit -- equal to 13 percent of GDP -- had pushed inflation close to a 900-percent annual rate. Import restrictions and sporadic price controls had induced a steep decline in output.

Under the leadership of Economics Minister Jose Alfredo Martinez de Hoz, the military regime immediately set out to

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reverse Peronist policies by instituting an economic reform program that touched nearly every aspect of the economy. Wages were frozen and labor union activities, including the rights to negotiate and to strike, were sharply curtailed. At the same time, most prices were freed to encourage production and eliminate black markets.

The junta undertook to restructure the onerous foreign debt and rebuild reserves. Breaking Argentine tradition, it approached the IMF as well as foreign banks for loans. To boost exports, the new government reversed previous policies favoring industry over agriculture. In addition to offering strong price inducements to grain farmers, it abolished the state grain board's monopoly of the grain trade and returned most marketing operations to private hands.

During its first 21 months, the regime took major steps to reduce state involvement in the economy and to increase the role of market forces. Trade restrictions were eased, exchange rates were freed, banks were allowed to make their own loan decisions -- instead of acting as Central Bank agents -- and interest rate controls were removed. Moreover, new laws eliminated restrictions on foreign investment that had choked off the inflow of funds.

Finances were overhauled to reduce the vast government deficit. New taxes were imposed and enforcement tightened. Several government enterprises -- including the oil monopoly -- were restructured to make them financially independent, and a start was made toward selling off

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unprofitable firms nationalized during the Peron period.

Achievements Under the Reform Program

Foreign payments difficulties were overcome quickly, after Martinez de Hoz persuaded the IMF and commercial banks to loan the $1 billion needed to restructure the foreign debt and a good grain-growing season permitted farmers to harvest a bumper export crop. By the end of 1977, 21 months after assuming power, the junta had:

- Achieved a trade surplus half again as large as the $1 billion deficit it inherited.
- Raised reserves to a level equal to a year's imports.
- Cut the budget deficit to 3 percent of GDP.
- Lowered the inflation rate to 160 percent.

Reversing two years of decline, GDP grew by 4.4 percent in 1977. Growth would have been even greater had the authorities not deliberately slowed the pace when a third-quarter surge threatened to erase gains against inflation. Total investment grew 25 percent -- to equal nearly 30 percent of GDP -- and foreign investment was up by $250 million, or nearly 10 percent, for the year. Since wage restraints enabled businesses to keep workers on payrolls even though not fully utilized, unemployment reached a record low of 2.2 percent in October. This was a major factor in preventing major confrontations with labor despite the low level of real wages.

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Inflation -- The Chief Remaining Problem

The main economic stumbling block at present is inflation, with its related problems of low real wages and business illiquidity. Real wages are now about 15 percent below the 1975 level. Although they have risen 10-12 percent over the past year, they remain low enough to keep consumer demand depressed. Many small businessmen have been squeezed -- some to the point of bankruptcy -- by declining profits and rising costs, especially financing costs. Heavy demand for financing caused interest rates to turn positive in third quarter 1977 -- for the first time in years -- and many borrowers went abroad for funds at lower rates.

With inflation control as its chief economic goal for 1978, the government has taken several antiinflationary steps. In addition to continuing general wage restraints, it has cut import tariffs to force Argentine products into price competition with foreign goods. It has also tightened export financing procedures to reduce the amount of credit extended.

Most important, it has prepared a 1978 budget designed to eliminate the fiscal deficit as a source of inflation. The deficit is to be held to 1 percent of GDP and financed entirely by borrowing. With strict tax enforcement to keep revenues high, spending is to be further reduced -- a difficult goal in view of the huge investment program

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inherited from the Peron regime. Public investment is budgeted at 12 percent of GDP in order to continue work on major projects already under way. Salary allocations cannot be cut much, despite a planned reduction in the number of public employees, because the regime wants to upgrade salaries to prevent competent people from moving to better-paying private sector jobs.

Overall, the government is maintaining its gradualist approach to the problem. Private credit restrictions will not be allowed to greatly inhibit growth, real wages will be permitted to rise slowly, and unemployment will continue to be avoided. Despite reports that government working plans for 1978 are based on an inflation rate of 60 percent, we believe that a rate just under 100 percent is the best that can be expected -- especially after last month's inauspicious 13-percent rise.

Toward Sustained Growth

Real growth is now close to the Argentine norm of 4-5 percent. Real GDP spurted 7.9 percent in third quarter 1977 on the strength of rapidly rising exports, a sharp upturn in investment, and buoyant construction and industrial activity; it then was slowed to 4 percent in the fourth quarter by monetary restrictions. Although the tightened credit policy continues to dampen demand, investment is picking up and should soon offset the sluggishness.

Most businessmen expect the economy to continue to grow. Industrial production and exports have been rising.

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Although agriculture as a whole will not do as well as in 1976-77, because of less favorable weather and lower international grain prices, increased output of sorghum and soybeans will partially compensate for a sharp drop in the wheat harvest. Foreign investment will probably rise as terrorist incidents become less frequent.

The Payments Situation

The balance of payments should remain favorable in 1978, although the trade surplus will be considerably smaller. Exports, which reached $5.7 billion in 1977, will probably not exceed $5 billion in 1978, mainly because less grain is available. Increased exports of soybeans, meat, and manufactures will not fully offset the drop in grains. Meanwhile, imports will exceed 1977's $4 billion because of industry's need for more imported materials and equipment. The trade surplus should cover debt service payments but will not raise reserves as sharply as in the past two years.

The Political Backdrop

Continued economic progress depends on continued political stability. The present economic team has good credibility and can be expected to follow through on its plans unless pressure from critics or an eruption of labor unrest forces a shift.

Labor problems are a definite possibility. Although the government expects rising productivity to permit

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noninflationary wage hikes, the size and timing of wage increases have not been clearly delineated. Workers are uncertain about their prospects. Their uneasiness is compounded by the lack of a clear line of communication between them and the government as long as union activities reamin curtailed. Terrorist organizations, though decimated, could try to exploit this gap.

Some prominent critics feel that workers have already made excessive sacrifices and should now receive concessions. Others feel that illegal labor actions, such as sporadic strikes that have occurred despite prohibitions, should be dealt with severely. So far, Martinez de Hoz, firmly backed by President Videla, has carefully steered between these divergent points of view, and it does not appear that any critics, either within the government or outside it, wield sufficient influence at present to cause a change of line. If, however, he is forced to yield ground on wages, his efforts to control inflation will be seriously hampered. If, on the other hand, more repressive measures are taken against labor, not only would economic recovery be disrupted but the slow restoration of human rights in Argentina could be jeopardized, with predictable results for the nation's international reputation.

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Argentina: Balance of Payments

$million

	1974	1975	1976	1977 (Prel.)	1978 (Proj.)
Current account	127.2	-1284.6	650.1	1500	500
Trade balance	295.8	- 985.2	883.6	1700	700
Exports (FOB)	3930.7	2961.3	3916.1	5700	5000
Imports (CIF)	-3634.9	-3946.5	-3032.5	4000	4300
Net services and transfers	- 168.6	- 299.4	- 233.5	- 200	- 200
Capital account	- 241.5	488.0	567.7	600	300
Private	- 111.8	116.8	- 281.9	50	
Public and banking sectors	- 129.7	371.2	849.6	550	
Change in reserves	- 51.3	- 791.1	1192.4	2100	800
Errors and ommisions	- 63.0	5.5	- 25.4	-	-

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Argentina: Statistical Data

GDP Annual Growth Rates (%)

1971	3.7
1972	3.8
1973	4.8
1974	7.2
1975	-1.4
1976	-2.9
1977	4.4

Budget Deficits (as % of GDP)

1970	1.7
1971	4.3
1972	5.2
1973	7.3
1974	9.4
1975	15.1
1976	6.0
1977	3.0

Foreign Reserves (US $ million, end of year)

1971	374
1972	541
1973	1,462
1974	1,411
1975	620
1976	1,800
1977	4,000 (Est.)

Inflation (% increase)

1971	39
1972	64
1973	44
1974	40
1975	335
1976	348
1977	160

Money circulation (billion pesos, end of period)

1971	22.5
1972	32.1
1973	73.6
1974	122.8
1975	336.3
1976	495.3 (First quarter)
	762.2 (Second quarter)
	1,050.3 (Third quarter)
	1,363.3 (Fourth quarter)
1977	1,739.7 (First quarter)
	2,299.8 (May)

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Argentina (cont'd)

Wheat production (1,000 tons)

1970/71	4,920
1971/72	5,680
1972/73	7,900
1973/74	6,560
1974/75	5,970
1975/76	8,570
1976/77	11,200
1977/78	5,200 (Est.)

Petroleum production (1,000 barrels/day)

1971	423
1972	433
1973	420
1974	412
1975	394
1976	397
1977	430 (Est.)

Steel production (1,000 tons)

1971	1,915
1972	2,106
1973	2,154
1974	2,354
1975	2,284
1976	2,409
1977	2,673

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